1974

Recognition of profit on sales of receivables with recourse : recommendation to Financial Accounting Standards Board. June 14, 1974; Statement of position 74-06;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position on

74-6

Recognition of Profit on Sales of Receivables With Recourse

June 14, 1974

Recommendation to Financial Accounting Standards Board

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

AICPA

American Institute of Certified Public Accountants
666 Fifth Avenue, New York, New York 10019 (212) 581-8440

June 14, 1974

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the AICPA Accounting Standards Division on Recognition of Profit on Sales of Receivables with Recourse. It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement takes the position that a uniform accounting approach is desirable for the recognition of profit or loss on sales of receivables with recourse and that the "delayed recognition" method rather than the "immediate recognition" method is preferable. This position is reached by examining the types of transactions in question, presenting the two prevalent methods of accounting for such transactions, describing the rationale supporting the use of each, and reviewing present accounting literature.

The Statement also examines the possibility that these transactions may be separated into the sale of receivables, on the one hand, and the retention of credit risks, on the other, profit and loss being allocated for each of these two elements of the overall transaction. A majority of the Executive Committee finds this method impracticable in most cases and without adequate theoretical basis. A minority finds that the technique is, under certain circumstances, not only practicable but preferable.

Finally, the Statement sets forth recommended methods of systematic amortization for the "delayed recognition" approach and presents guidelines on disclosure for these transactions.

The Division would appreciate being advised as to the Board's proposed action on these recommendations.

Sincerely yours,

Stanley J. Scott (jw)

STANLEY J. SCOTT
Chairman
Accounting Standards Division

SJS/Lc

Enclosure

RECOGNITION OF PROFIT ON SALES OF RECEIVABLES WITH RECOURSE

Contents

Introduction

1. The Accounting Standards Division (the Division) of the American Institute of Certified Public Accountants has reviewed the accounting practices used by business enterprises for the recognition of profit (or loss) on sales of receivables with recourse.[1/] The review indicated that in current practice two accounting methods are widely used in these transactions. The review also found that both accounting methods have been in use within specific industries. These two accounting methods are discussed in the "Current Practice" section of this Statement.

2. In recent years accountants, regulatory authorities, investors, and other users of financial statements have expressed concern over the acceptability of alternative accounting methods in accounting for similar business transactions. The Division believes that it is not desirable to have alternative accounting methods acceptable for the recognition of profit on sales of receivables with recourse. Therefore, the Division is expressing in this Statement its position on a preferable method. Its position is set forth below under "The Division's Position".

[1/] The term recourse in the context of this Statement refers generally to the contractual right of a purchaser of receivables to demand payment from the seller of such receivables in the event of default by the debtor. However, the term may also refer to agreements between a buyer and a seller of receivables, such as guarantees by the seller of a "yield" to the buyer on the receivables sold, which constitute "recourse" in substance.

3. The scope of this Statement is restricted to the subject of profit (or loss) recognition on sales of receivables with recourse. This Statement does not discuss and is not intended to apply to the sale of receivables on a non-recourse basis, the recording of transactions giving rise to receivables, the imputation of interest on receivables[2/] or the presentation of sales of receivables with recourse in financial statements.

4. The Division's position as set forth herein applies to financial statements which purport to present financial position, changes in financial position, or results of operations in conformity with generally accepted accounting principles. It also applies to regulated companies in accordance with the provision of the Addendum to APB Opinion No. 2, Accounting for the Investment Credit (1962).

2/ Provisions for recognizing the appropriate rate of interest on receivables are discussed in APB Opinion No. 21, Interest on Receivables and Payables, and those provisions are applicable to the initial recording of transactions giving rise to receivables.

Terminology

5. The key terms in this Statement are defined below as they are used herein. Some additional definitions will be given as the need arises in the course of this Statement.

6. Receivables. Receivables recorded under generally accepted accounting principles represent contractual rights to receive monies. They may arise from sales of products or services in the normal course of business which are due in customary trade terms (generally less than one year) and sales made pursuant to conditional sales contracts which are payable in monthly installments over periods often ranging from 3 to 10 or more years. Receivables may also arise from lending activities, such as mortgage loans for the purchase of real estate, direct cash loans to individuals, loans to businesses to finance working capital, and loans for other purposes. Certain contractual rights to receive monies, such as those related to unperformed portions of executory contracts, are ordinarily not recognized as receivables under generally accepted accounting principles.

7. Face amount. The face amount is the sum of money outstanding on a legal instrument that obligates a party to pay another party a specified amount. It may be the exact amount expressed on a note, bond, conditional sales contract, etc. The face amount of a receivable may comprise some or all of the following:

(a) The sales price of goods or services sold or the amount of a cash loan.

(b) Finance charges (interest) to be collected and earned during the term of the receivable for the use of monies.

(c) Service charges assessed the debtor for initiating the receivable, including such out-of-pocket costs as filing fees and credit investigation reports.

(d) Fees for maintenance contracts purchased by the debtor and insurance premiums for various types of insurance coverage (generally credit life insurance, credit accident and health insurance, or fire and casualty insurance).

8. Net receivable. The net receivable is the face amount of the receivable less related unearned finance and service charges, unearned amounts applicable to executory contracts, and amounts included in the face amount for which the creditor's function is solely that of an agent (such as insurance premiums to be collected and remitted to an insurance company). Sometimes the net receivable is equal to the face amount.

9. Executory contract amount. The executory contract amount is the amount included in the face amount of a receivable representing the unperformed portion of an executory contract (such as a maintenance, management, or service agreement).

10. Agency amount. An agency amount is an amount in the face amount of a receivable representing the cost to the debtor of a service for which the seller or lender has acted only as an agent. Insurance premiums and maintenance fees may be agency amounts.

11. Differential. The differential is the difference, after adjustment if necessary for executory contract and agency amounts, between the amount for which the receivable is sold and the net receivable. This difference is variously referred to as "endorsement fee", "participation fee", "placement fee", "interest differential", and "finance fee". In those cases where the amount of the net receivables exceeds the amount for which the receivables are sold, the difference is usually termed "discount" or "loss". In this Statement only the term "differential" will be used to describe the difference arising from the sale of receivables at either more or less than the net receivables.

Background and Nature of Transactions

12. Some companies occasionally or regularly "package" some or all of their receivables and sell them to financial institutions or others to meet their financing needs. There is usually a difference between the net receivables and the amount for which the receivables are sold. In many instances the volume of receivables sold by companies is substantial, and the differential arising from such transactions is significant in the determination of results of operations of the seller. In addition to the volume of receivables sold, the differential may be dependent on such factors as the general level of interest rates, the stated interest rate of the receivables, the credit standing of the seller, the length of the payment period of the receivables, and the type and value of any security. Often receivables are sold on a recourse basis, and the seller of the receivables is obligated to reacquire the receivables in the event of a default by the debtor. The

types of recourse arrangements will be examined after the calculation of the differential is explained.

13. The examples below illustrate how differentials may be calculated. They are presented only as illustrations. Because there are many possible variations in agreements involving the sale of receivables, the determination of the differential will depend on the circumstances in each case. Although these illustrations assume the sale of whole receivables, there may also be sales of portions of receivables or groups of receivables in bulk without specific identification. In the cases below note that Example A includes the finance charges (add-on interest) in the face amount, whereas Example B does not. Example C illustrates a contractual arrangement that includes finance charges and executory items in the face amount.

Example A:

Sales price of goods	$10,000
Less initial payment received	1,000
Net receivable (balance to be financed on an installment contract payable over 120 months)	9,000
Add-on finance charges (14% per annum effective interest rate)	7,769
Face amount of receivable (payable $139.74 per month)	$16,769
Amount for which receivable is sold, i.e., face amount of receivable discounted to yield 10-¼% to the buyer (present value at 10-¼% of $16,769 payable over 120 months)	$10,464
Net receivable	9,000
Differential	$ 1,464

Example B:

Original amount (principal) of a 6% note payable in equal monthly installments of $119.90, including interest, over 360 months	$20,000
Principal amount of 120 payments received to date of sale of receivable	3,263
Face amount and net receivable	$16,737
Amount for which receivable is sold, i.e., net receivable discounted to yield 8% to the buyer (present value at 8% of 240 monthly payments of $119.90)	$14,335
Face amount and net receivable	16,737
Differential	$(2,402)

Example C:

Sales price of goods	$5,000
Credit life insurance premium for a 3 year, single premium contract	150
Maintenance contract for 3 years	300
Total	5,450
Less initial payment received	500
Balance to be financed on an installment contract payable over 36 months	4,950
Finance charges at 12% per annum	968
Face amount of receivable (payable $164.39 per month)	$5,918

Example C (Continued)

Amount for which receivable is sold, i.e. face amount of receivable discounted to yield 10% to the buyer (present value at 10% of $5,918 payable over 36 months)	$5,095
Net receivable ($4,950 less $300 maintenance contract fee and $150 credit life insurance premium)	4,500
Difference between the amount of proceeds and the net receivable	595
Less adjustment for executory item and insurance premiums ($300 maintenance contract fee and $150 credit life insurance premium)	450
Differential	$ 145

14. When receivables are sold on a recourse basis, the form of recourse arrangements may vary. In some situations the buyer of the receivables is obligated to return any collateral security for the receivable to the seller before the seller is compelled to perform under the recourse arrangement. In other cases a mere default on payment by the debtor will obligate the seller to reacquire the receivable. In some instances the buyer of the receivables may remarket any goods it obtains by repossession and apply the proceeds therefrom against the receivable balance. In that event the seller may be required to pay any deficiency in the receivable balance remaining after the application of such proceeds. Sometimes the liability of the seller with respect to recourse provisions is limited to stipulated amounts or percentages of the receivables sold. Such partial recourse arrangements may, however, provide the buyer adequate assurance of the recovery of his investment after considering the value of the collateral securing the receivable. In addition to reacquiring the receivable, the seller may also be required to refund to the buyer a portion of the differential originally received on the defaulted receivable,

thus effectively guaranteeing the buyer a stipulated investment yield. Although the form of recourse arrangements may vary, in all cases the seller retains risks.

15. The buyer's security in these transactions is frequently derived from a provision for the temporary retention by the buyer of a portion of the amount for which the receivables are sold. Such retained amounts are often referred to as "dealers' reserves" or "hold-backs". The terms governing "dealers' reserves" are defined in the agreement between the buyer and the seller of receivables. The amount of such "dealers' reserves" may be determined by the buyer based on loss experience developed from previous transactions with the seller or others. Amounts retained in "dealers' reserve" accounts are sometimes remitted to the seller as the reserve account exceeds stipulated percentages of the uncollected receivables. Agreements may provide that the "dealers' reserves" be charged for credit losses or rebates of finance charges resulting from either early extinguishment by the debtor or default. Some agreements may limit the buyer's recourse to the seller to amounts set aside in the "dealers' reserve". However, in most cases "dealers' reserves" represent a substantial security for the buyer's investment.

16. The agreement between the buyer and the seller of receivables stipulates which party is to perform administrative and collection functions for the receivables sold. These functions are usually referred to as "servicing". If the seller retains the servicing functions, the agreement may provide for a "servicing fee" to be paid by the buyer. If the agreement does not specifically provide for compensation to the party performing the servicing, compensation for the future servicing will nevertheless be reflected in the amount for which the receivable is sold. Because the ultimate cost of the obligation to service is not determinable at the time of sale, the servicing provision necessarily enters into the degree of risk retained by the seller and accordingly influences the amount of the differential.

17. Although, as previously mentioned, the unperformed portions of executory contracts are ordinarily not recognized as receivables under generally accepted accounting principles, they may be included in the face amount of the receivable. Executory contract amounts usually enter into the risks retained by the seller. Normally these amounts are refundable to the buyer in the event of default, prepayment, or cancellation of a maintenance contract, etc., by the debtor. Therefore they influence the amount for which the receivable is sold and the differential and perhaps other terms of the agreement between the buyer and seller.

18. There may be types of financing arrangements comparable in substance to transactions involving the sale of receivables. For example, a company may obtain from a lender a firm commitment[3/] to provide financing to its customer prior to closing the sales transaction with the customer. In such cases at the time the sale is closed the customer receives the products or services sold, the lender obtains a receivable, and the company receives cash or other assets from the lender. In addition to receiving proceeds equivalent to the sales price of the product or services sold, the company may receive from the lender a portion of the finance charges stated in the receivable obtained by the lender. If the company guarantees the lender against loss arising from default by the debtor, the portion of the finance charges received from the lender is in substance the differential. To take another type of example, participation agreements or factoring arrangements, if they provide for recourse, may also be comparable in substance to transactions involving the sale of receivables and give rise to differential. In such cases the concepts discussed in this Statement regarding the recognition of profit arising from the sale of receivables with recourse are equally appropriate.

[3/] Financing commitments may be obtained directly from a lender or indirectly through intermediaries such as servicing companies.

Current Practice

19. The following paragraphs discuss the two accounting methods commonly used by business enterprises for the recognition of profit on sales of receivables with recourse. For the purposes of this Statement, those two accounting methods are termed the "delayed recognition" method and the "immediate recognition" method. The delayed recognition method emphasizes the financing aspects of the transaction. The immediate recognition method considers the sale of receivables with recourse a completed transaction giving rise to immediate profit or loss.

20. Sums obtained from the sale of receivables with recourse are sometimes treated as borrowings, with an accounting result for profit recognition similar to that in the delayed recognition method. When these transactions are treated as borrowings, the differential is not explicitly accounted for. In these cases the differential is in effect accounted for as two separate elements: an element representing interest income on the receivables and an element representing interest expense on the borrowing. The Division has not compared the borrowing treatment to the two accounting methods for recognizing profit on such sales because this Statement does not address the question of financial statement presentation for these transactions. However, much of what is said in this Statement about the delayed recognition method applies also to the borrowing treatment because of the similarity they share both in their accounting result for profit recognition and in their basic assumption, i.e., that the sale of receivables with recourse is primarily a financing transaction.

Delayed Recognition Method

21. As stated above, the delayed recognition method emphasizes the financing aspects of the sale of receivables. The differential is recognized in the income statement in a systematic manner over a period of time usually corresponding to the term of the receivables sold. Usually no provision is recorded for refunds of differential in the event of default by the debtors or in the event of prepayment of the receivables. No separate provision for such refunds is required because the deferred differential contains an effective reserve for them. Similarly, the differential contains an effective reserve for any future administrative and collection functions to be performed by the seller. An allowance for uncollectible receivables, including estimates of expenses of and losses on repossessions, is customarily made in the accounting for receivables. This allowance remains in effect after the receivables are sold.

22. The rationale advanced for use of the delayed recognition method includes:

(a) The sale of receivables with recourse is in substance a type of financing, in effect a borrowing by the seller. When a selling price is negotiated, the negotiating process is analogous to that which occurs between a borrower and a lender. In determining an acceptable return for his investment, the buyer of receivables takes into account the seller's retention of certain risks and his ability to meet those risks, i.e., his credit standing.

The buyer's return is then reflected in the dollar amount for which the receivables are purchased. If the receivables were never sold, the interest income on the receivables and the costs of "borrowed" funds used to finance the receivables would be recognized in results of operations over the term of the receivables. The differential represents interest income on the receivables, net of interest expense on funds effectively borrowed to finance the receivables. Therefore, the delayed recognition method accounts for the economic substance of the transaction.

(b) "Realization"[4/] occurs with the passage of time as the risks retained by the seller are diminished by payments made on the receivables, which reduce the amounts subject to refund in the event of default or prepayment. Thus, recognition of differential in income should coincide with the periods in which the risks that the differential may be refundable under the recourse provision diminish.

(c) The method used for recognition of differential in income should be similar to that used by financial institutions in accounting for finance income because the differential essentially represents interest. The differential, taken together with the allowance for uncollectible accounts, represents the aggregate credits to which future losses should be charged.

4/ See paragraphs 37-39 for a discussion of the realization principle.

23. In its review of current accounting practices, the Division found that the delayed recognition method is used predominantly by financial institutions (e.g., finance companies, banks, and savings and loan associations). However, this method is generally not used to recognize differential when the amount for which the receivables are sold is less than the net receivables. Even if the differential is a negative amount, the rationale for the delayed recognition method maintains that the analogy to financing transactions is valid. In such cases the buyer has negotiated a rate of interest from the seller that is higher than the rate that the seller had obtained from the debtor when the receivables were initially recorded. The buyer's higher rate discounts the receivables to a purchase price resulting in a negative differential. Negative differential is customarily termed "discount" or "loss". For those who account for sales of receivables with recourse as borrowings, the transactions involving negative differentials are simply characterized by a higher interest rate on the borrowed funds.

Immediate Recognition Method

24. The immediate recognition method considers the sale of receivables with recourse a completed transaction giving rise to profit or loss at the time of sale. Under this method the profit or loss recognized is equivalent to the differential. A provision is made for refunds of differential in the event of default by the debtors or of prepayment of the receivables. If the seller is to perform future administrative and collection functions, a provision is made for their cost. An allowance for uncollectible receivables, including estimates of expenses of and losses on repossessions, is customarily made in the accounting for receivables, and this allowance remains in effect after the receivables are sold.

25. The rationale advanced for use of the immediate recognition method includes:

(a) The sale of receivables with recourse is a completed transaction. It is a three-party transaction, including a seller, a lender, and a debtor. The seller is in effect acting as a broker for the buyer of the receivables and is obtaining a commission to compensate him for his services (such as writing and packaging the receivables) up to the date the receivables are sold. If there is an analogy to financing in these transactions, it is due primarily to the relationship between the lender and the debtor. The lender must be concerned about the debtor's credit standing and ability to fulfill his obligations, whereas the seller's recourse obligations are only of secondary importance to him. The differential should therefore be recognized immediately because the earning process is complete.

(b) The seller's recourse obligations are similar to a manufacturer's obligations under product warranties or guarantees. In effect, the seller guarantees the quality of the receivables sold and should account for the consequences of such a guarantee in the same manner that a manufacturer accounts for its obligations under product warranties. Provisions are made in the period of sale for refund of the differential in the event of default by the debtor or in the event of prepayment of the receivables and also for future administrative and collection functions to be performed by the seller.

In addition, an allowance for uncollectible receivables is made. Immediate recognition of differential is therefore appropriate.

26. In studying the use of the immediate recognition method the Division found that it is often employed by retailers and dealers in automobiles, mobile homes, furniture, jewelry, and home appliances and by certain companies whose primary business is servicing receivables originated by others. The Division also observed that if a seller has purchased credit insurance for protection against losses from default by the debtor, no provision is made for uncollectible accounts because the insurance company assumes those risks. In such cases, however, provision is usually made for refunds of differential resulting from default or prepayment by the debtor because such amounts are not covered by the insurance. Finally, when the immediate recognition method is used, negative differential is recognized immediately as loss. The immediate recognition of negative differential as loss is consistent with the rationale in support of this method.

27. The Division also found certain procedures which could be categorized either as a variation of the immediate recognition method or the delayed recognition method. For example, even if differential is being allocated over the term of the receivables, there are variations in the pattern of allocation. Another variation arises when differential is deferred to the extent that the buyer has retained a "dealers' reserve", and differential is recognized as profit only as amounts are released from the reserve. In this case the pattern of release may make the technique more or less similar to either method.

28. Although certain procedures may be categorized as variations of either method, the distinction between the two methods is nonetheless important because it defines the two ends of the spectrum of revenue recognition for sales of receivables with recourse. The significant difference between the immediate recognition method and the delayed recognition method is in their respective timing of revenue recognition. The immediate recognition method isolates an amount that is recognized as profit at the date of sale. Under the delayed recognition method no profit is recognized at the date of the sale, rather all profit is recognized over the term of the receivables.

Additional Accounting Method

29. In addition to the two accounting methods previously discussed in this Statement, the Division considered another method of accounting for profit or loss on sales of receivables with recourse. For the purpose of the following discussion, this additional accounting method is termed the "nonrecourse-market" method.

30. The nonrecourse-market method is predicated upon the assumption that a sale of receivables with recourse has at least two distinctive aspects, the sale of the receivables and the retention of credit risks by the seller, and that profit or loss can be allocated to each aspect of the transaction. The first aspect of the transaction, the sale of receivables, is considered to be complete at the time of the exchange. The profit allocable to this aspect of the transaction is the amount of premium or discount that would have resulted

from a sale of the same receivables on a nonrecourse basis. The "premium or discount" is a component of the differential. It is the equivalent of the differential if the same sale had taken place without any recourse provision. Because the sale of the receivables is considered to be complete at the time of the exchange, the premium or discount is recognized in income in the period the receivables are sold.

31. The second aspect of the transaction is the retention of credit risks arising from the recourse provisions. Assuming that no other aspects (such as servicing) are present in the transaction, the amount of differential allocable to the second aspect of the transaction is termed the "credit risk" component. This component of the differential is deferred at the time the receivables are sold and is recognized in income as the seller's risks diminish over the period of time the receivables are to be outstanding. If either component can be measured, the value of the other may be obtained by subtraction.

32. In some cases a transaction involving the sale of receivables with recourse may involve more than just the two aspects discussed above. For example, the seller of the receivables may continue to service the receivables sold. If a servicing fee is not specifically provided for by the agreement between the seller and the buyer, a portion of the differential received by the seller would be deferred and recognized as income by the seller over the servicing period.

33. The theoretical basis of the nonrecourse-market method may be challenged on the ground that the isolation of a risk-free component of the differential does not accord with the contractual obligations of the seller. Under the nonrecourse-market method the credit risk component of the differential is separated at the time of the sale from the premium component, which is immediately recognized as profit. However, at that point the recourse provision applies to every dollar of differential. At any point during the term of the receivables the differential, no matter how accounted for, is refundable to the extent of a buyer's loss from default or prepayment by a debtor.

34. In any event, the effectiveness of the nonrecourse-market method is dependent on a reasonable assessment of the various components of the differential associated with each aspect of the transaction. The Division found that in certain cases data was available to compare the sale of receivables with and without recourse. In some cases, when the receivables are sold without recourse, the buyer insures them with an independent insurance company. If the nonrecourse-market method were to be applied to sales with recourse, the credit risk component of the differential could be measured by the insurance premium that would be paid to insure a buyer of receivables purchased without recourse against default by the debtor. In a limited number of cases information is available about the amount for which specific receivables can be sold on either a recourse or nonrecourse basis, with the difference in the two amounts being attributed to retention of the credit risks. In most cases, however, the Division believes that such measurements would not be

objective because insurance rates are influenced by competitive forces within the insurance industry, because within a single industry the risk of default on receivables varies according to the proportion of the debtor's obligation that is met by his down payment, because the risk of default also varies according to the nature of collateral security provided by the seller, and because of other factors. Even when there is a difference between the prices at which receivables are offered for sale with and without recourse, such difference may be attributable to the financial strength of the seller as well as to the characteristics of the receivables being offered for sale.

Present Accounting Literature

35. The Division found in existing pronouncements of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board no definitive guidance on accounting for profit or loss on sales of receivables with recourse. In fact, no specific pronouncement has been devoted exclusively to these transactions. However, the Division also examined recent pronouncements on applicable general principles to see if they provided clear guidance. The following paragraphs summarize the applicable general principles.

Revenue and Profit Recognition

36. The concepts of revenue realization are discussed in Accounting Principles Board Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises (paragraphs 148 through 153). Realization is described as follows: "Revenue is generally recognized when both of the following conditions are met: (1) the earning process is complete or virtually complete, and (2) an exchange has taken place" (paragraph 150). The term

"earning" is described as "a technical term that refers to the activities that give rise to the revenue--purchasing, manufacturing, selling, rendering service, delivering goods, allowing other entities to use enterprise assets, the occurrence of an event specified in a contract, and so forth" (paragraph 149). APB Statement No. 4 holds that the realization principle requires that revenue be earned before it is recognized as income. Monies received or amounts billed in advance of the delivery of goods or performance of services are reported as unearned revenue until the earning process is complete.

37. According to APB Statement No. 4, revenue may not be recognized without an exchange, and the timing of revenue recognition is generally determined by the time of the exchange. For example, revenue from the sale of a product is generally recognized upon delivery of the product to the customer; revenue from services is recognized when the services have been performed; revenue from the sale of assets other than products is recognized at the date of the sale; and revenue from permitting others to use a business's resources (such as interest, rent, and royalties) is recognized as time passes or as the resources are used.

38. In order for a sale to result in recognizable profit, the collection of the sale price must be assured. Accounting Research Bulletin No. 43 states, "Profit is deemed to be realized when a sale in the ordinary course of business is effected unless the circumstances are such that the collection of the sales price is not reasonably assured." This statement was reaffirmed in paragraph 12 of APB Opinion No. 10 in which the APB concluded that the installment method of recognizing revenue is not acceptable unless the circumstances are such that the collection of the sales price is not reasonably assured.

The Current Trend

39. The Division noted in recent pronouncements issued by the AICPA an increasing emphasis on deferring the point at which the earning process is considered to be complete and revenue and profit are recognized. This trend is evidenced by the accounting concepts set forth in the AICPA industry accounting guides Accounting for Franchise Fee Revenue, Accounting for Profit Recognition on Sales of Real Estate, Accounting for Retail Land Sales, and Accounting for Motion Picture Films and in APB Opinion No. 27, Accounting for Lease Transactions by Manufacturer or Dealer Lessors. According to these publications the completeness of the earning process may be determined based on such factors as (a) the transference from the seller to the buyer of the risks and rewards of ownership in the asset sold and (b) the seller's continuing involvement in the property sold (e.g., an obligation to perform services without reasonable compensation, guaranteeing a return to the buyer, or an obligation by the seller to repurchase the property sold).

40. The Division also noted that accounting literature stresses that the economic substance of a transaction should determine the method of accounting (including the timing for revenue and profit recognition) if the economic substance of the transaction differs from its legal form. APB Statement No. 4 states, "Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented."

The Division's Position

41. The Divison finds persuasive the rationale advanced for use of the delayed recognition method. Sales of receivables with recourse have significant characteristics of financing transactions in which monies are borrowed and assets are pledged as security thereon. This conclusion is based on the fact that the seller's risks have not been diminished by the sale transaction and on the fact that the differential has the attributes of finance income. The seller's risks are retained by the recourse provision, which also effectively pledges his assets as security for the sum advanced by the buyer. The differential represents primarily the difference between the value of the interest on the receivables sold and the value of the interest on the funds advanced by the buyer. The interest rate at which the buyer is willing to advance funds to the seller reflects the fact that risks are retained by the seller and also reflects his credit standing. These considerations are implicit in a lending transaction. The Division therefore concludes that the use of the delayed recognition method is preferable to the use of the immediate recognition method.

42. For reasons outlined earlier in this Statement the Division questions the theoretical basis of the nonrecourse-market method and believes that practical problems usually prevent reasonable measurement of the components of the differential. It therefore believes the method should not be accepted. A minority of three members of the Accounting Standards Executive Committee dissents from this position. They believe that there are situations where the credit risk component is clearly measurable and in those instances the nonrecourse-market method is practicable and preferable.

Application of the Delayed Recognition Method

43. The variations that the Division noted in the patterns of recognizing deferred differential suggest that divergent accounting treatments are in use. The Division therefore offers in this section its views on how the delayed recognition method should be applied.

44. Use of the delayed recognition method calls for the amortization to operations of the differential as the risks of the seller diminish, thereby recognizing income as the earning process is completed. In order to recognize the diminishing risks of the seller the differential must be divided into its two essential elements, interest income and interest expense.[5/] The differential can then be amortized by obtaining the net result of the accounting for the two essential elements. Although this division is necessary in order to account for income as risks diminish, in the financial statements the differential should be presented as a net amount.

[5/] Allowances for uncollectible receivables are not part of the differential and should be accounted for separately. They are customarily made in the accounting for the unsold receivables and remain in effect after the receivables are sold, unless the risks of default by the debtor are assumed by others (e.g., a credit insurer). After the receivables are sold, allowances for uncollectible receivables should be adjusted as necessary.

Differences arising between the financial accounting for periodic recognition of profit or loss on sales of receivables and the income tax accounting for such profit or loss should be treated as timing differences in accordance with APB Opinion No. 11, Accounting for Income Taxes.

45. The Division believes the element equivalent to interest expense should be accounted for as is customary in accounting for the cost of borrowed funds, that is, by application of a constant rate of interest to the amount outstanding at the beginning of a given period. The amortization to operations of the element equivalent to interest income should recognize the costs and diminishing risks of the seller. This may be achieved by any of four procedures. The choice of the most appropriate procedure should be governed by the circumstances. The interest income element may be accounted for by application of a constant rate of interest to the amount of receivables outstanding at the beginning of a given period. It may also be accounted for, depending upon the circumstances, by using one of the three methods provided by the AICPA Industry Audit Guide Audits of Finance Companies. According to this Guide, interest income, referred to as "deferred finance income", may be accounted for by the combination method, the effective yield method without transfer, and the pro rata method with transfer. The Guide also presents criteria for the use of other methods that may be more practical in certain circumstances.

46. The Division recognizes that at times the buyer's recourse to the seller for defaults by the debtor or refunds of differential may be limited to specific maximum amounts (e.g., the amount in a "dealers' reserve") which will cause practical problems in application of the delayed recognition method in the manner described in the preceding paragraph. If it is not practicable to divide the differential into interest income and interest expense elements, the differential may be amortized by approximating the collections of the receivables and taking differential into income as the risks are thereby diminished. The goal of amortizing the differential

to operations as the seller's risks diminish may be approximated by the sum-of-digits method when the receivables are payable in regular, equal installments.

47. Direct costs incurred during the sale of receivables with recourse may be deferred and amortized to operations on a basis that will match such costs with the amortization of the differential. Costs directly incurred during the consummation of these sales (such as legal fees and costs of preparing and processing documents for transferring ownership of the receivables to the buyer) are similar to costs that might be incurred in the issuance of debt. These costs must be distinguished from the direct or indirect costs incurred in order to derive revenue from the sale of goods or service.

Disclosure

48. The Division believes that disclosures for the sale of receivables with recourse should go beyond the minimal requirements called for in Accounting Research Bulletin No. 50, Contingencies. In general, disclosure should include the nature and amount of the receivables sold during each period in which an income statement is presented, specifying the payment terms, and the amount of any receivables still outstanding at the date of the latest balance sheet presented. In addition, the financial statements should disclose the terms of the agreements, describing the conditions that would compel the seller to perform under the recourse provisions and any provisions for "dealers' reserves". The amount of funds in the "dealers' reserves" at the date of the latest balance sheet presented should also be given.

49. The Division believes that a company's accounting policy for profit or loss on the sale of receivables with recourse should be disclosed in accordance with the provisions of APB Opinion No. 22, Disclosure of Accounting Policies. The amount of differential included in each period for which an income statement is presented and the amount deferred at the date of the latest balance sheet presented should also be disclosed.

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June 14, 1974

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